SPEECH

DATE:	8 December 2008
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My time at the Riksbank

Some final reflections on challenges along the way

On a chilly day in January 1976 I crossed the threshold of the newly-built Riksbank building for the first time. It was true that all employees were moving into the new building that day, which contributed to the more or less organised chaos of furniture gone adrift and employees trying to find their new offices. But for me it was probably an extra special day. It was my first day at work. And it was my first job outside of the university after taking my PhD.

Almost 33 years have passed since that day in January. And as I leave the Riksbank at the end of the year one could say that I have come full circle. It was where I began my career. In 1986 I left the bank, but in January 2003 I once again crossed the threshold at Brunkebergstorg 11, then as one of the six members of the Executive Board. This will now be my final full-time job.

The years have been eventful ones, with more than a little drama from time to time. From the oil crisis, stagflation and repeated devaluations of the krona during my first period at the Riksbank, to the aftermath of the IT crash and terrorist actions on 11 September 2001, the invasion of Iraq and substantial fluctuations in energy and commodity prices during my time on the Executive Board. In between this we had the early 1990s with an economic crisis, severe problems in Swedish banks and the transition from a fixed exchange rate to a floating krona. The global financial crisis we are now in the midst of is the latest addition to the list. But the major events have not only been in the outside world. Partly as a result of these "external" developments, the way we work at the Riksbank has also undergone a dramatic change. This applies to everything from the actual task we have and our working methods to our communication and degree of openness.

There have been plenty of challenges, and there are probably plenty more waiting around the corner. At the moment we are in a much more difficult situation for the economy than we have experienced for many years, with a worldwide financial crisis and a period of weak growth ahead of us. But at the same time, we are much better equipped to manage this type of situation today than when I first started at the Riksbank. Both we and others have learnt a lot along the way, remedied various deficiencies and tried to create something that works better. Of course, this process is never at an end, but I can nevertheless note that we have come a long way. As I now hold my final speech as member of the Executive Board, I would like to take this opportunity to give my own perspective on parts of this journey, on the challenges we have faced and on what may lie ahead of us.

An organisation that is constantly developing

A lot has changed since my first day at work in 1976, not only outside of, but also inside of the Riksbank's walls. My workplace of the 1970s in practice has little more in common with today's Riksbank than the building itself. It is quite simply a different world.

Credibility and better conditions

Today economic policy has a different credibility, and also the tools needed to deal with shocks to the economy in a flexible way. A long development process lies behind this much better starting point with "greater room for manoeuvre". Something that has been a decisive factor is the changes in the economic policy framework made following the crisis at the beginning of the 1990s. Sweden was then forced to get to grips with many problems that had been around for a long time. There was also broad support, not least from politicians, behind the demands for change.

Both monetary and fiscal policy were transformed and with good results. The inflation target for monetary policy, the fact that the Riksbank now has statutory independence and the fact that we now have sound public finances, a budget ceiling and balance targets for fiscal policy – all of this has contributed to much greater stability in the economy than we had in the 1970s and 1980s. The current regulations mean that economic policy as a whole can never seriously clash with the monetary policy target in the way it actually sometimes did during the period with a fixed exchange rate regime.

Both public authorities and banks also learned a lot about financial stability during the crisis in the 1990s. The Riksbank now has an organisation that continuously analyses the stability of the financial system and maintains a preparedness to act in a potential crisis situation. This gives us the opportunity to detect and counteract at any early stage any changes and vulnerabilities that could lead to a serious crisis. It also makes it easier to manage the problems if a crisis were to occur. The experiences of both the Riksbank and others have definitely given us better resilience to the current global financial crisis than we would otherwise have had.

There are several reasons why we now have greater credibility and better conditions to do our job efficiently. One is most probably that openness and clarity have long been, and still are, of central importance. Our policy works much better and more efficiently when we are open and clear about our objectives and the reasons for our decisions. An important piece of the puzzle is that we now have a "direct" and clear inflation target. Although the fixed exchange rate was aimed "indirectly" at providing low and stable inflation, this was not really as clear. But with a fixed exchange rate monetary policy is also governed by external events, which has both advantages and disadvantages.

Up to the beginning of the 1990s, the Riksbank was on the whole a closed and rather secretive institution, just like most other central banks at that time. Today the situation is the opposite. We are now considered one of the world's most open central banks. The fact that an independent authority must provide opportunities for insight and evaluation is natural in our society. Another aspect that may be of importance is that the openness puts a little extra pressure on us to develop and do our job as well and as efficiently as possible. And I can note that our methods have changed substantially.

Willingness to change and rapid development in our working methods

The fact that a lot has happened since the mid-1970s when we sat and drew diagrams and forecasts by hand on graph paper is not surprising. But even during my period in office the last six years our methods of working have shown a rapid development. One driving force is of course that the world around us is constantly changing – and often very quickly. Quite simply, there are new demands made on us from outside, which we must deal with as best we can. Developments during the financial crisis in recent months are a good example of this. There are also demands from outside regarding our interaction with the general public, with other public authorities and with you who work in the financial markets. It is important that we communicate and work together efficiently, both to ensure monetary policy functions smoothly and to safeguard financial stability.

But the pressure for changes does not only come from outside. We are constantly working on developing our working methods. It may not always be apparent to those who do not work at the Riksbank, but there is a strong will among our employees to improve our ways of thinking and working. There is a positive driving force behind the changes we are implementing. I am convinced that this driving force has contributed to the fact that we now have much better working methods than before. Another positive driving force is the regular contacts we have with other central banks and with the academic world.

The developments cover everything from new methods to our communication. Something that constitutes an example of both of these things is the forecast for the repo rate path that we now publish regularly. Another is the alternative scenarios for the development of the economy that we describe in our Monetary Policy Reports to highlight the most important uncertainty factors we see ahead of us. These scenarios enable us to show in an easy-to-understand and coherent manner how a particular development might affect monetary policy and our forecasts in general. None of this would have been possible without the developments in working methods, particularly in the field of modelling, that have taken place in recent years. These have created an entirely new flexibility and new opportunities in our methods of working and communicating.

Technological advances and better tools create new opportunities

When we make our forecasts for developments in the economy, we have a number of different tools at our disposal. We have the assessments made by experts in the different fields. We also have economic theories, past developments and various models on which to base our analysis. All of these components are important and they complement one another. Previously, we were often more or less forced to rely to a great extent on assessments rather on the more formal analysis. This provided some restraints.

Now we have the technical possibility to make model-based forecasts for the economy that are coherent and based on different factors and markets being mutually dependent. If a particular variable changes, the entire system is adapted in the model simultaneously with the change. Perhaps our most important tool in this field is the general equilibrium model known as RAMSES. We also use a number of other, simpler models as economic indicators. But although developments in this field have made huge advances, the models cannot entirely capture the complex reality we live in. They have their limitations and deficiencies and it is important to be aware of these. And of course we do not base our forecasts and decisions solely on what the models show. Their results are supplemented to a large degree with expert analyses. This applies in particular to situations like the current one, when certain mechanisms in the economy are not functioning entirely as normal.

But despite model-based analysis having certain deficiencies, the developments in this field mean we have obtained a much more useful aid in our work. We can act work in a more systematic manner when making our forecasts than was possible before and I would also claim that we have a better base for making our decisions. This has also made it possible to become even more open and clear with regard to our view of the future. There is a positive interaction here. As I mentioned earlier, the openness acts as an extra incentive with regard to developing our working methods.

It is not only with regard to monetary policy that we have made progress in our working methods. The tools for analysing the stability of the financial system have also been improved. This increases the chances of detecting at an early stage changes and vulnerabilities that could lead to a serious crisis. It also becomes easier to work on prevention and in various ways to counteract a serious crisis from arising. The developments include methods regarding what are known as stress tests, which analyse what happens to the banks during various sequences of events and crisis scenarios. Such models are of course important tools when it comes to crisis exercises and to adapting our preparedness for managing real crisis situations efficiently.

Challenges along the way

A lot has changed, both compared with when I first began at the Riksbank and over the past six years. We have better conditions for managing various challenges so that we can attain our inflation target and safeguard financial stability in the best possible manner. It is also largely a case of learning by doing. I would therefore like to take up some of the challenges that we and other central banks have had to deal with in recent years. These are challenges we have learnt from when we were forced to deal with them. They are also challenges that in one way or another will stimulate future developments.

Rising commodity prices,…

In May of this year I held a speech on the upward pressure on international commodity prices that had been exerted for some time. This applied to both traditional commodities, such as oil and metals, and to foodstuffs, such as grain. The boom in commodity prices had pushed up inflation both here and abroad, and inflation was clearly overshooting our target. I maintained that this inflationary impulse and the risk of contagion effects to other prices and wages were something that could become the first serious test for low-inflation targeting around the world.

Seven months later, this prophecy does not seem so relevant any more. Commodity prices have fallen and inflation has begun to drop back from the high levels seen in the summer. The challenges now faced by central banks are of an entirely different nature than those of just a few months ago. Now the most important challenge is to safeguard the stability of the financial system and to try to limit the negative effects on production and employment. But I would nevertheless like to point out that what I said in May was important, although the financial crisis has come in between and made the problem of rising commodity prices less relevant for the time being.

There were several explanations as to why commodity prices rose so sharply. But the one I considered – and still consider – to be most important was that emerging economies with large populations, such as China and India, have increasingly begun to take part in the competition for global resources – resources which in many cases are finite.

This is probably a fairly lasting and long-term driving force. The emerging economies are undergoing a structural transformation that will probably take some time. Their demand for commodities will probably remain high in the future. Although the upward pressure on commodity prices has taken a time-out with the slowdown in world growth, in a year or two it may very well be a problem that central banks will once again need to manage.

At the same time, it is worth pointing out that this need not necessarily be a big problem. As I have observed, we now know a lot more about how monetary policy should be conducted than we did when I first arrived at the Riksbank in 1976 – in between the two oil crises. The problem of rising commodity prices can be managed within the prevailing framework for monetary policy. Essentially, it is a question of preventing what happened during the 1970s, namely that the inflationary impulses that the oil price shocks entailed were allowed to become entrenched and to spread to wages and other prices. But it is also important that the policy is not so tight that there are overly negative effects on production and employment. Of course, this is not an easy balancing act. But I can assure you that such deliberations lie behind every individual interest rate decision taken by the Executive Board.

…the debate on monetary policy and house prices,...

Another question that has arisen during my time as member of the Executive Board, and which is also fairly controversial, is how monetary policy should react when house prices and household indebtedness increase rapidly, which was the case in Sweden and many other countries until quite recently.

A common view has been that monetary policy should only react to a rapid credit expansion and price increase in the housing market if the forecasts made by the central bank indicate problems of, for instance, overheating and too high inflation in the coming period. If this is not the case, the central bank should wait and see, but be prepared to quickly ease monetary policy if the housing market were to collapse and demand in the economy were to fall drastically. One should not, as the expression goes, "lean into the wind", but make do with cleaning up afterwards if problems arise.

The main argument in favour of this way of acting is that the central bank is not better than others at assessing whether or not the price increase is due to over-optimistic calculations - if a bubble has arisen. If the bank makes the wrong assessment and raises the interest rate despite the events being justified by fundamental factors, demand will be pushed down unnecessarily. And even if the central bank were to be sure that the problem is over-valuation, the timing of the measures may be problematic. The hope is, of course, that tighter monetary policy will contribute to counteracting an imbalance. But if the central bank acts too late and, for example, raises the interest rate just before a bubble would nevertheless have burst of its own accord, monetary policy may instead contribute to worsening the fall in demand.

The view that the central bank should only react if the forecasts indicate problems may appear reasonable, but there are some uncertainties in this, particularly with regard to how this should be translated into practical policy. In situations where house prices and lending are rising very quickly, the central bank can see *risks* in this development, even if it cannot be sure whether a bubble is building up. It may then be difficult and even inappropriate to remain completely passive, even if the main line of the forecasts is that developments will be balanced. If house prices were then to plummet and pull down demand and inflation, the consequences could be very severe, which is clearly illustrated by the current financial crisis.

The conclusion the Riksbank has reached with regard to monetary policy is therefore that this type of risk may need to be taken into consideration in a different way than the normal procedure, via the forecasts for inflation and the real economy. As indicated in the policy document "Monetary Policy in Sweden", this could be done by beginning a phase of interest rate increases slightly earlier than would otherwise have been the case, or by postponing a phase of interest rate increases. In addition, we highlight and warn against various types of risk, for instance in our speeches and reports. This was how we acted for instance in 2006. The idea is that by cautiously leaning into the wind and in connection with this providing information about the risks, there will hopefully be less to clean up afterwards and in the best case scenario there will be no cleaning up to do at all.

Here it is worth noting that the Riksbank's development work has been made it easier to counteract tendencies towards imbalances with the aid of information. In that we now publish a forecast of the future repo rate, instead of assuming that it will remain unchanged, as we did a few years ago, it has become clearer to an outsider what we think of future interest rates. This information is important to those wanting to borrow money or to buy housing, for instance, if we foresee a series of interest rate increases ahead. The interest rate path also makes it possible to show in a simple, easy-to-understand manner how events may develop in the different risk scenarios. This could involve illustrating what would happen if, for instance, the housing market were to develop differently than in our main scenario.

Developments in the property market are also a very central part of the analysis of financial stability. This is natural, not least because property comprises a very large part of the banks' collateral for their lending. Here, too, information is perhaps our most important tool. For instance, in our Financial Stability Report we analyse the financial situation of the household sector and describe our assessment of the situation and potential risks with regard to house prices and indebtedness.

The way that monetary policy should manage risks linked to credit booms and rapidly-rising house prices is a difficult problem that will continue to be debated among central banks and in academia. We do not have a perfect solution to this problem. But I nevertheless think that it is a good example of how the Riksbank really tries to find practically-applicable ways of managing difficult challenges. And these must be managed, sooner or later.

...and of course – the financial crisis

I hardly need to say that the most dramatic thing that has happened during my period in office here is the global financial crisis. It is partly connected to the problems with house prices and indebtedness that I have just mentioned. The crisis is to a large degree a case of an imbalance – of excessive risks in lending and purely structural problems regarding supervision and insight.

After just over a year the crisis entered its most intensive phase in mid-September, in connection with the US investment bank Lehman Brothers suffering acute problems. Since then the Swedish financial system has been increasingly affected. The Riksbank and other authorities have taken extensive measures to counteract the effects of the crisis. These measures are still a necessary condition for maintaining satisfactory stability in the Swedish financial system.

The financial crisis has made the link between the Riksbank's two areas of activity – conducting monetary policy and safeguarding financial stability – very clear. The fact that financial stability is a necessary condition for monetary policy to function efficiently is fairly self-evident, but it is not perhaps something one thinks about as long as everything is functioning normally. But now that the financial markets are no longer functioning efficiently, this link becomes more important. As a result of the uncertainty and distrust prevailing between the banks and other financial institutions, the interest rates paid by the general public are higher than normal, seen in relation to the repo rate. Access to credit is also declining. The economic situation is therefore tightening more than the current level of the repo rate would normally allow. The crisis may also, if it is not counteracted, have significantly negative effects on inflation and growth. It affects the banks' loan losses to some extent, which in turn has significance for financial stability.

We need measures regarding both financial stability and monetary policy to resolve the confidence crisis causing a gridlock in the credit markets and to alleviate the effects of the financial crisis on the Swedish economy. The most recent measure taken was the interest rate cut of 1.75 percentage points to 2 per cent last week, when we also brought forward the meeting we would have held on 17 December. We have seen an unexpectedly rapid and broad weakening in economic activity and it is clear that this will continue to be weak in the coming period. Despite global and forceful measures to resolve the financial crisis and to alleviate its effects, it is still difficult and expensive to borrow, both for households and companies. The oil price and other commodity prices have continued to fall, which leads to lower cost pressures. Inflation will fall quickly and undershoot the target next year. We considered that a much lower repo rate was necessary to attain the inflation target a couple of years ahead and at the same time contribute to ensuring economic developments are not too weak. Another reason why such a large cut was necessary is that the interest rates paid by the general public recently as a result of the financial crisis have been higher than normal in relation to the level of the repo rate, which in itself has a constraining effect.

The financial crisis makes demands on us to be flexible, to act quickly and forcefully. We have tried to work in this way so far, not least by means of new solutions and measures we would not normally use. The fact that we are giving the banks the possibility to borrow in Swedish krona from the Riksbank at longer maturities than normal and that we have supplied loans in US dollars are examples of this. Other examples are the fact that we have scheduled an extra monetary policy meeting this autumn, that we brought forward our most recent interest rate decision and also the scope of the most recent interest rate cuts. Under the circumstances now prevailing in the global financial crisis, we six members of the Executive Board must be able to quickly agree on various measures. One of the advantages of allowing a central bank to be governed by a group of decision-makers is that it leads to better decisions when different opinions and types of competence are combined. However, one risk is that different opinions could create difficulties in reaching agreement and lead to a slower decision-making process. But our experience so far is that when our ability to act has been put to the test, we have managed to "deliver". The fact that we are a group of policy-makers who sometimes have different views of things has not been an obstacle.

Future challenges

The financial crisis is one of the most difficult challenges we have faced during my time at the Riksbank and the problems of dealing with it largely remain ahead of us. This is to a great extent a question of issues that need to be resolved on an international level. This includes, for instance, a review of the regulatory framework, the opportunities for insight and the fact that investors must be able, and have stronger incentives, to assess the risks to which they are actually exposing themselves. The broad spread of fairly complicated constructions of financial instruments that has contributed to the current confidence crisis in the financial markets is a clear example that risk awareness has been low.

There is currently a process under way where various authorities around the world are reviewing their regulations, supervision and general frameworks for crisis management. This applies not only on a national basis, but also at an international level. If, for instance, one does not harmonise the regulations for crisis management, one country's measures may create problems for another country. These are not merely challenges for the "external" systems. There are also challenges for our analysis framework. It is difficult to take credit markets and asset prices into account in a really good way in our forecasts. Some work still remains in this field, for instance, with regard to finding good ways to include asset prices and other financial variables in models of the whole economy. There is a lot of work going on in this field in many parts of the world, not least at the Riksbank. I also believe that there will be many developments in this area, too, over the coming years.

Concluding remarks

It has been incredibly interesting and stimulating to work at the Riksbank. And it is possibly even more stimulating today than when I first began here. I must confess that it feels a little strange to know that I will no longer be "on the inside" and involved in managing the challenges we face. My period at the Riksbank is not ending in a quiet phasing out, but rather on a crescendo. Being involved and trying to contribute to ensuring that the Swedish economy can cope with difficult periods as well as possible is one of the most challenging and stimulating parts of the job as member of the Executive Board of the Riksbank. This was one important reason why I returned to the Bank six years ago. But now I will nevertheless leave the Bank when my period of office comes to a close.

There is much that I am already aware that I am going to miss. For instance, doing what I am doing right now, giving a speech to well-informed and interested listeners, and receiving their questions and comments on economic developments. I will also miss the more day-to-day work at the Bank. As I believe you will have noticed from my speech today, I consider there is a willingness to change at the Riksbank – positive driving force to develop and become better at what we do. It is a very stimulating environment to work in. It is this corporate culture and all of the devoted employees who create it, that I will miss most of all. As I now leave my post as member of the Executive Board, it feels comforting to know that this driving force for development exists in our organisation. This, together with the changes that have been made, both with regard to the framework for economic policy and our means of working, convinces me that the Riksbank will be perfectly able to manage the challenges that await us in the future.